State of Rhode Island and Providence Plantations
STATE INVESTMENT COMMISSION

Regular Meeting September 22, 2004

A State Investment Commission ("SIC") meeting was held in Room 135, State House, Providence, Rhode Island on Wednesday, September 22, 2004. There being a quorum present, the Treasurer called the meeting to order at 9:10 a.m.

Membership Roll Call. Present were: Mr. Michael Costello, Ms. Rosemary Booth Gallogly, Ms. Marcia Reback, Mr. James E. Thorsen, Mr. John R. Treat, and General Treasurer Paul J. Tavares. Dr. Robert McKenna joined the meeting at 9:14 a.m. and Senator Daniel DaPonte joined the meeting at 9:15 a.m. Also present were: Mr. George Carvalho, Chief of Staff, Ms. Joan M. Caine, Deputy Treasurer for Finance, Mr. William G. Bensur of Wilshire Associates Incorporated, Consultant to the Commission, Ms. Tara Blackburn of Pacific Corporate Group, Alternative Investments Consultant to the Commission, and other members of the Treasurer's Staff. Jayne Donegan, Esq. of Brown Rudnick Berlack Israels, Legal Counsel to the Commission, joined the meeting at 9:35 a.m.

State Investment Commission Minutes. Mr. Costello moved, Ms. Gallogly seconded and the following motion was passed unanimously. The following members voted in favor: Mr. Costello, Ms. Gallogly, Ms. Reback, Mr. Thorsen, Mr. Treat, and Treasurer Tavares. Note: Sen. DaPonte and Dr. McKenna were not present for this vote.

VOTED: To approve the Minutes of the August 25, 2004 Regular Meeting.

Proposed Alternative Investment – Aurora Equity Partners III, L.P. ("Aurora"). Ms. Blackburn of Pacific Corporate Group ("PCG") gave a brief overview of Aurora, which is being formed by the principals of Aurora Capital Partners to make equity and equity-related investments in businesses controlled by Aurora. Fund III will continue the investment strategy of Aurora's prior funds, pursuing a middle-market buy-and-build strategy. Target capitalization of Fund III is $900 million. Target IRR is a minimum of 20% net to investors.

Mr. John Mapes, Managing Partner and Mr. Richard Roeder, Partner represented Aurora. Mr. Mapes noted that the middle-market companies Aurora invests in will be in the industrial or service industries. Aurora will not invest in businesses with a high risk of technological change or low barriers to entry. In the past, Aurora has bought small companies and combined them to form larger companies. Aurora has invested $1.03 billion in fourteen portfolio companies since inception in 1991. Overall, Aurora's investments have generated a net IRR of 13.1%. Realized investments have generated a gross IRR of 39.3%.

Mr. Roeder noted that the fund will focus on industries where the principals believe they can make a platform acquisition for $100-$200 million in equity, attract strong management and create value by improving operations, increasing revenue through internal growth and acquiring smaller or weaker competitors.

Mr. Thorsen moved, Ms. Reback seconded and the following motion was passed unanimously. The following members voted in favor: Mr. Costello, Sen. DaPonte, Ms. Gallogly, Dr. McKenna, Ms. Reback, Mr. Thorsen, Mr. Treat, and Treasurer Tavares.

VOTED: To invest up to $15 million in Aurora Equity Partners III, L.P., contingent upon satisfactory review and negotiation of investment and other legal documents.

Investment Manager Review – MacKay Shields ("MacKay"). Mr. Bensur gave a brief overview noting that MacKay was retained in 2002 to provide a long-term, strategic exposure to the general investment characteristics of the high yield segment of the US fixed income market. As of 6-20-04, the market value of this portfolio was $116.8 million. MacKay comprises approximately 7.5% of the fixed income composite and approximately 1.9% of the total fund.

Mr. Kirk Kashevaroff, Director and Mr. Donald Morgan, Senior Managing Director and Portfolio Manager represented MacKay. Mr. Kashevaroff noted that MacKay was founded in 1938, is owned by New York Life Insurance Co., and has approximately $15 billion of assets under management in the high yield product. Mr. Morgan noted that the portfolio performed well over the last two years. MacKay's guidelines allow up to 20% in CCC rated securities, which have been the best performing of high yield bonds over the last 18-24 months. MacKay now sees less value in CCC's and are lowering the portfolio's weighting to those lower rated securities. Guidelines also allow up to 10% in bank debt, which contributed positively to performance.

Mr. Morgan reported that year-to-date performance is up 3.16%, one year performance is up 15.84% and since inception (approximately two years) is up 26.94%. The portfolio is diversified with weightings in utilities (which includes pipelines), information technology, diversified media, paper, telecommunications, wireless communications, automotive and other services. He noted that lower credit quality outperformed significantly from 4Q02 to present. Current strategy is to gradually raise credit quality by reducing CCC/B- exposure and to increase exposure to selected cyclicals.

Mr. Kashevaroff discussed MacKay's recent purchase of Pareto Partners ("Pareto"). He stated that MacKay was concerned that legislation might be passed prohibiting a manager from running a hedge fund and a mutual fund at the same time. In order to have a back-up plan in place, MacKay has entered into an agreement to purchase Pareto's high yield and global high yield business. Pareto's High Yield group will provide additional capacity due to a complementary fit with MacKay's current high yield product.

The high yield products of both MacKay and Pareto have strong investment returns long term, but they are arrived at differently. MacKay's product historically tended to perform better in strong markets and had higher volatility. Pareto's product tended to perform better in more difficult markets, and has had lower volatility. Both have a strong disciplined investment process that leads to a differing selection of bonds and hence, different investment performance.

At this time, prior to Shenkman Capital Management, Inc. ("Shenkman") joining the meeting, Mr. Bensur brought Commission members up-to-date on the fact that there is a great disparity in the returns of the two high-yield management firms. He noted that MacKay and Shenkman were hired and funded at the same time to complement each other. However, MacKay's return since inception is 26.67% and Shenkman's return is 11.12%. He noted that a disparity of 15% is an enormous amount and extremely unusual for managers in the same sector. Mr. Bensur wanted to call attention to Shenkman's underperformance so Commission members are aware of the problem prior to his Manager Continuation Policy report later in the year.

Investment Manager Review – Shenkman Capital Management, Inc. Ms. Kim Hekking, Senior Vice President of Client Service and Marketing and Mr. Mark Shenkman, President and

CIO represented Shenkman. Mr. Shenkman stated that the firm was a conservative, defensive manager of high yield bonds, the only product Shenkman offers. He explained that Shenkman has not varied from their style, strategy or credit process. Shenkman does not invest in high-risk industries or buy volatile companies. Shenkman avoided the high default industries such as telecom, utilities and airlines, which turned out to be the best performers of the last year. This contributed to the poor performance. He stressed that Shenkman has an unwavering investment philosophy and no style drift.

Ms. Caine noted that Shenkman had approximately $6 billion of assets under management when hired in 2002, but that in 2004 assets under management have doubled to $11.6 billion. Mr. Shenkman stated that although assets have doubled, the amount of clients had not. He stated that most of the increase was from existing clients. The number of employees has increased from 32 to 62, and the average size of an account is a little over $100 million. The high yield bond universe is 1,500 securities but Shenkman's approved list includes just 439 securities.

Mr. Shenkman noted that high yield market drivers include: US economic trends, market liquidity, corporate developments, new issue supply and expected default rates. He believes that the high yield market has recovered and that the outlook appears favorable for the balance of the year. Bonds that appreciated most due to momentum rather than fundamentals could experience the biggest correction if their underlying credit statistics falter. Market liquidity remains favorable as dealers are still willing to commit capital to the high yield market. Default rates should continue to decline. Mr. Shenkman stated that he and Frank Whitley will continue to manage the portfolio.

Wilshire Associates Incorporated ("Wilshire") – Contract. Ms. Caine reported that the Treasurer was in receipt of a request from Wilshire for an increase in their fee schedule. The request is to increase the annual investment consulting fee from the current annual retainer of $200,000 to $250,000 effective October 1, 2004. Wilshire has not had an increase in their fee since 1995. Ms. Caine noted that the current fee charged is lower than most states are paying their consultants. The Treasurer and Ms. Caine recommended that the Commission approve the fee increase.

Ms. Reback moved, Dr. McKenna seconded and the following motion was passed unanimously. The following members voted in favor: Mr. Costello, Sen. DaPonte, Ms. Gallogly, Dr. McKenna, Ms. Reback, Mr. Thorsen, Mr. Treat, and Treasurer Tavares.

VOTED: To approve Wilshire Associates' proposed fee schedule increase, as outlined in their letter dated September 21, 2004.

Note: Mr. Costello left the meeting at 11:10 a.m.

Wilshire Associates Incorporated – Capital Market Review. Mr. Bensur noted that there were signs of economic expansion although there are still uncertainties. The Fed raised rates again to 1.75%. On a year-to-date basis (through September 21, 2004), the S&P is up 2.7%, the Nasdaq is down 4.1%, the Russell 2000 is up 4.0%, and the Wilshire 5000 is up 3%. The international market is up 4.7% and the fixed income market is up 3.6%.

Deputy Treasurer for Finance Report. Ms. Caine noted that in July she reported that the Fund's unaudited returns for the fiscal year showed a total return of 19.6%. Since that time, Wilshire has submitted audited figures showing a total return of 19.5%. For the first two months of this fiscal year, the fund is down 1.5%. She noted that July was a very difficult month. Mr.

Bensur noted that the TIPS mandate was put in place at exactly the right time and was up 2-3% in August.

New Business. Ms. Reback raised a question regarding cash withdrawals from money managers. Ms. Caine and Treasurer Tavares stated that on a monthly basis approximately $20 million is withdrawn from managers to cover cash flow shortages. The money is taken from managers that are either over allocated or ones that have cash on hand. Regarding the American Express Building, Treasurer Tavares reported that the September payment has been paid and that negotiations were ongoing regarding the loan agreement and related promissory notes which mature on December 1, 2004.

Dr. McKenna moved, Ms. Reback seconded and the following motion was passed unanimously. The following members voted in favor: Sen. DaPonte, Ms. Gallogly, Dr. McKenna, Ms. Reback, Mr. Thorsen, Mr. Treat, and Treasurer Tavares. Note: Mr. Costello was not present for this vote.

VOTED: To adjourn the meeting.

There being no further business, the meeting was adjourned at 11: 20 a.m.

Respectfully submitted,

Paul J. Tavares
General Treasurer